LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS

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FISCAL IMPACT STATEMENT

LS 6556 **DATE PREPARED:** Dec 27, 2001
BILL NUMBER: SB 297 **BILL AMENDED:**

SUBJECT: Elimination of Inheritance Tax.

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FUNDS AFFECTED: X **GENERAL**
DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: The bill exempts Class A transferees from the Inheritance Tax beginning January 1, 2003. The bill also phases out the Inheritance Tax for Class B and Class C transferees by increasing exemption amounts in 2003 and 2004. The bill provides that the Inheritance Tax does not apply to Class B and Class C transferees after December 31, 2004. The bill provides that the Indiana Estate Tax does not apply to the estate of an individual who dies after December 31, 2004. The bill also provides that the Indiana Generation Skipping Transfer Tax does not apply to the estate of an individual who dies after December 31, 2009, and before January 1, 2011. The bill repeals Inheritance Tax statutes on January 1, 2007, and makes conforming amendments.

Effective Date: July 1, 2002; July 1, 2007.

Explanation of State Expenditures: *Inheritance Tax Repeal:* Once the Inheritance Tax is repealed, there could be a savings to the state from a reduction in staff in the Inheritance Tax Section of the Department of State Revenue. The October 2, 2001, state manning table indicates that the Inheritance Tax Section has 15 full-time employees and one part-time employee. The annual salary cost for these employees is $464,334. Since staff members would still be needed to process returns, a specific savings due to staff reductions could not be estimated.

County Inheritance Tax Replacement: In addition to eliminating Inheritance Tax revenue to the state, the bill would, over a three-year period, eliminate the resident Inheritance Tax revenue retained by the counties. The estimated revenue loss to the counties and county replacement payments by the state are summarized in the table below. As a result of the revenue loss, the bill would increase expenditures from the state General Fund relating to the Inheritance Tax replacement for counties. The maximum amount of county replacement for any year is approximately $7.5 M. With the repeal of the Inheritance Tax, this amount would continue to be paid to the counties. Since the Inheritance Tax does not have to be paid until a maximum of 12 months after the decedent's death (within 9 months of the date of death to receive the 5% early payment discount), the impact of the bill is not expected to begin until FY 2004. (See *Explanation of Local Revenues*, below, for further explanation of the replacement procedure.)

Fiscal Year	County Inheritance Tax Loss	State Expenditures for County Replacement
2004	6.7 M	6.7 M
2005	7.0 M	7.0 M
2006 & after	9.9 M	7.5 M

Explanation of State Revenues: *Inheritance and Estate Taxes:* The bill would lead to a progressively larger reduction in revenue from the Inheritance Tax from FY 2004 to FY 2006 when it is estimated that the state would no longer receive revenue from the tax. In addition, the bill could potentially lead to an increase in revenue from the Estate Tax until FY 2007. This offset by the Estate Tax will decline to zero by FY 2007 due to increases in the federal unified credit and the phaseout of the federal state death tax credit. (Note: Consistent with federal changes, the bill effectively eliminates the Indiana Estate Tax beginning with 2005 decedents.) The estimated impact of the bill on Inheritance Tax and Estate Tax revenue and the net loss to the state including county replacement funding is presented in the table below. The estimates are based on the Revenue Technical Committee's updated FY 2003 forecast as of November 14, 2001, for the Inheritance and Estate Taxes. They assume that Inheritance Tax revenue will remain the same in subsequent years, but make adjustments to forecasted Estate Taxes to account for the elimination of the Indiana Estate Tax in concert with the repeal of the state death tax credit under the federal Estate Tax.

Fiscal Year	Inheritance Tax Revenues	Estate Tax Revenues	Less: State Expenditures for County Replacement	Net Increase (Decrease)
2004	(77.8 M)	11.0 M	(6.7 M)	(73.6 M)
2005	(80.6 M)	15.8 M	(7.0 M)	(71.8 M)
2006	(115.2 M)	4.9 M	(7.5 M)	(117.8 M)
2007 & after	(115.2 M)	0	(7.5 M)	(122.7 M)

Generation Skipping Transfer Tax: The bill prohibits the Indiana Generation Skipping Transfer Tax from applying to estates of decedents who die during 2010. This conforms to the repeal of the federal Generation Skipping Transfer Tax to which the Indiana tax is linked. According to the Department of State Revenue, this tax has accounted for very little revenue during its history. As a result, any impact this provision may have will occur well into the future and likely will be very minimal.

The Indiana Generation Skipping Transfer Tax depends on a credit against the federal Generation Skipping Transfer Tax. The federal tax and credit are to be repealed in 2010, but could return in 2011 as a result of a sunset provision on the federal legislation that included the repeal. In order to comply with the Congressional Budget Act of 1974, the provisions of this legislation will sunset on December 31, 2010. Congressional observers expect that the provisions of the Act will be extended or made permanent at some point in the future. Reportedly, the House leadership has indicated that legislation to make the provisions of the Act permanent will be considered in the near future.

Background on Inheritance Tax: The bill phases out the Inheritance Tax over a three-year period by providing a complete exemption in the first year for transfers to Class A transferees and an increasing exemption during the three-year period for transfers to Class B and Class C transferees. In the third year of the phaseout, a complete exemption is provided for transfers to Class B and Class C transferees. The particular exemptions depend upon whether the person making the transfers died on or after specified dates. The exemptions and applicable dates are presented in the table below. (Under current law, Class A transferees are entitled to a $100,000 exemption; Class B transferees to a $500 exemption; and Class C transferees to a $100 exemption.) Since the Inheritance Tax does not have to be paid until a maximum of 12 months after the decedent's death (within 9 months of the date of death to receive the 5% early payment discount), the impact of the bill is not expected to begin until FY 2004.

Class A Exemption	**Class B Exemption**	**Class C Exemption**	**Transfers made . . .**
Complete	$100,000	$20,000	After December 31, 2002, and before January 1, 2004
Complete	$120,000	$24,000	After December 31, 2003, and before January 1, 2005
Complete	Complete	Complete	After December 31, 2004

The estimated impact of the bill is based on an Office of Fiscal and Management Analysis (OFMA) database consisting of Inheritance Tax returns relating to decedents who died between July 1, 1997, and June 30, 2000. The database consists of 112,951 transferee records. It is assumed that the sample is representative of the universe of persons paying the Inheritance Tax. Of the total tax liability for the sample, 39.43% is attributable to Class A transferees, 35.35% is attributable to Class B transferees, and 25.22% is attributable to Class C transferees. The estimated revenue loss is based on the Revenue Technical Committee's updated FY 2003 forecast (as of November 14, 2001) for the Inheritance Tax equal to $140 M and assumes that revenue in FY 2004 will remain the same. The forecast total includes revenue from the Indiana Estate Tax. Based on FY 2001 collections, roughly 17.7% of this total is derived from the Estate Tax. This suggests that Inheritance Tax revenue is forecast at approximately $115.2 M and Estate Tax revenue at $24.8 M. Given the distribution of Inheritance Tax liabilities in the sample, it is estimated that approximately $45.4 M of this forecast is attributable to Class A transferees; approximately $40.7 M is attributable to Class B transferees; and approximately $29.1 M is attributable to Class C transferees. The increase in the Class B exemption reduced the tax liability of the sample Class B transferees by 60.37% in the first year of the phaseout and 64.89% in the second year of the phaseout. The increase in the Class C exemption reduced the tax liability of the sample Class C transferees by 26.83% in the first year of the phaseout and 30.21% in the second year of the phaseout.

Background on Estate Tax: Although the bill does not make changes to the Indiana Estate Tax, the reduction in Inheritance Tax liabilities for certain transferees could potentially have an impact on Estate Tax revenues. Indiana Estate Tax is owed on the assets of an estate if (1) federal Estate Tax is owed on the estate and (2) the Indiana portion of the state death tax credit for federal Estate Tax purposes exceeds the total Inheritance Tax paid by transferees of the estate. Consequently, for some estates a reduction in the Inheritance Tax liability paid by transferees of the estate results in a compensating increase in the Estate Tax liability.

The estimated impact of the bill on Estate Tax revenues is based on an OFMA database of Estate Tax returns relating to decedents who died between July 1, 1997, and June 30, 2000. The database consists of 559 estates upon which Indiana Estate Tax was paid. The phaseout of the Inheritance Tax for the sample increased the Estate Tax liability of the sample by a factor of 1.6 for FY 2004, 5.8 for FY 2005, and 6.6 for FY 2006. The recent federal law changes accelerate the scheduled increase in the unified credit and begin phasing out the state death tax credit in 2002. These estimates are increase by the factors specified above to derive the impact of the Inheritance Tax changes on the Estate Tax.

Explanation of Local Expenditures:

Explanation of Local Revenues: The phaseout of the Inheritance Tax is estimated to result in a net revenue loss to counties beginning in FY 2004. The annual impact on the counties is presented below.

Fiscal Year	County Inheritance Tax Revenues	State Expenditures for County Replacement	Net Increase (Decrease)
2004	(6.7 M)	6.7 M	0
2005	(7.0 M)	7.0 M	0
2006 & after	(9.9 M)	7.5 M	(2.4 M)

It is important to note that a reduction in the amount of Inheritance Tax retained by counties due to the bill may be reimbursed by the state under the replacement provision established by P.L. 254-1997. The replacement provision was established when the Class A exemption was increased on July 1, 1997. The replacement provision guarantees that in each fiscal year each county receives an amount under the Inheritance Tax that is equal to the five-year annual average amount of Inheritance Tax revenue retained by that county from FY 1991 to FY 1997, excluding the highest and lowest year. Therefore, a reduction in tax retained by a county due to the bill would be reimbursed only to the extent that the changes made by the bill cause the amount of tax revenue retained by the county to fall below its guaranteed amount. Currently, most counties are retaining more Inheritance Tax revenue than is guaranteed under the replacement procedure. The net impact of the bill assumes that the revenue loss to the counties will be fully reimbursed by the State in FY 2004 and FY 2005, but not in subsequent years when the replacement cap of $7.5 M is reached. A copy of a spreadsheet showing the amount of Inheritance Tax replacement guaranteed to each county under P.L. 254-1997 is available from the Office of Fiscal and Management Analysis.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties.

Information Sources: State Revenue Forecast, November 14, 2001; Bill Reynolds, Indiana Department of State Revenue, 232-2075; OFMA Inheritance and Estate Tax Databases; OFMA County Replacement Spreadsheet.